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EXPOSURE DRAFT

PROPOSED STATEMENT ON

AUDITING STANDARDS

OMNIBUS STATEMENT ON AUDITING STANDARDS

MARCH 23, 1982

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by May 21, 1982, and addressed to
AICPA Auditing Standards Division, File 1200
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775



American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

March 23, 1982

Accompanying this letter is an exposure draft of a proposed Statement on Auditing Standards entitled *Omnibus Statement on Auditing Standards*. A summary of the proposed SAS also accompanies this letter.

Comments or suggestions on any aspects of this exposure draft will be appreciated. The AICPA Auditing Standards Board's consideration of responses will be helped if the comments refer to the section and specific paragraph number and include supporting reasons for any suggestions or comments.

In developing guidance, the AICPA Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

For purposes of soliciting comments, this exposure draft shows only those paragraphs to which changes are being proposed. Each section for which an amendment is being proposed includes a brief summary explaining the purpose of the changes.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after June 21, 1982, for one year.

Responses should be sent to the AICPA Auditing Standards Division, File 1200, in time to be received by May 21, 1982. For your convenience, a post-paid mailer is attached to this exposure draft.

Sincerely,

A handwritten signature in cursive script that reads "James J. Leisenring".

James J. Leisenring
Chairman, Auditing Standards Board

A handwritten signature in cursive script that reads "D. R. Carmichael".

D. R. Carmichael
Vice President, Auditing

SUMMARY

This proposed Statement on Auditing Standards consists solely of amendments to existing statements. The board did not consider any single amendment extensive enough to warrant issuance as a separate statement, but the changes being proposed are considered significant enough to require amendment of existing statements rather than interpretation. Only the paragraphs being amended are shown and only the new wording is presented. The proposed amendments' anticipated effects on practice are outlined in the following paragraphs.

SAS No. 1, Section 150: Generally Accepted Auditing Standards

This amendment would replace current paragraph 6 with a new paragraph clearly stating that the ten generally accepted auditing standards apply to all services covered by Statements on Auditing Standards to the extent that they are relevant. For example, independence, the second general standard, applies to engagements covered by SAS No. 30, *Reporting on Internal Accounting Control*; however, the requirement to state whether financial statements are presented in accordance with GAAP, the first standard of reporting, would not apply because it is not relevant.

SAS No. 1, Section 320: The Auditor's Study and Evaluation of Internal Control

This amendment would replace paragraphs 51 through 55 of the current literature with new paragraphs numbered 51 through 58. Paragraphs numbered 56 onward in the current literature would be renumbered appropriately.

This amendment would clarify the minimum study and evaluation of the system of internal accounting control contemplated by the second standard of field work. The review of internal accounting control may be limited to obtaining an understanding of the control environment and the flow of transactions.

The minimum documentation required under this section would also be clarified. Documentation may be limited to a record of the auditor's reasons for deciding not to extend his review of the system of internal accounting control past the minimum level and the general effect of that decision on his audit procedures. If the auditor does not plan to rely on internal accounting control, he need not document his understanding of the internal accounting control system. This means, for example, that the auditor need not fill out an internal control questionnaire when he does not plan to rely on internal accounting control.

SAS No. 1, Section 331: Receivables and Inventories

This amendment would replace paragraphs 14 and 15 with a new paragraph 14. Subsequent paragraphs would be renumbered appropriately.

This amendment adds a new potential audit procedure to those suggested for inventories held at outside warehouses if the inventories represent a significant proportion of total or current assets. The additional potential procedure is the obtaining of an independent auditor's report on the warehouseman's system of internal accounting control, such as those covered by the exposure draft of the proposed SAS, *Special-Purpose Reports for Use by Other Auditors*.

SAS No. 1, Section 420: Consistency of Application of Generally Accepted Accounting Principles

Paragraph 16 would be eliminated, and additional language would be added to paragraph 15. Subsequent paragraphs would be renumbered appropriately.

The board has concluded that changes made in the terms used to express changes in financial position (such as cash, cash and cash equivalents, or working capital) between periods are reclassifications, and, therefore, the auditor does not need to qualify his report because of inconsistent application of accounting principles. Adequate disclosure of such a change is still required.

SAS No. 1, Section 901: Public Warehouses — Controls and Auditing Procedures for Goods Held

This amendment would replace paragraphs 1 through 5 with a new paragraph 1; subsequent paragraphs would be renumbered appropriately. The amendment would make an editorial change in paragraph 28 and changes paragraph 32 to reference suggested audit procedures to SAS No. 1, section 331.14.

This amendment would bring those procedures considered necessary for inventories held at public warehouses into conformity with those contained in SAS No. 1, section 331, as modified by the amendment described earlier.

SAS No. 2, Paragraph 39: Reports on Audited Financial Statements

This amendment would change the language of the example "subject to" qualification included in this paragraph.

Reports qualified due to an uncertainty should not contain language that refers to "the effects, if any," on the financial statements "of the ultimate resolution" because of the requirements of FASB Statement 16, *Prior Period Adjustments*. This amendment clarifies the language that an auditor should use in reports qualified due to an uncertainty by removing any reference to effects of the future resolution of matters on the current financial statements.

SAS No. 5, Paragraphs 5 and 6: The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report

This amendment would replace those paragraphs with new paragraphs numbered 5, 6, and 7. Subsequent paragraphs would be renumbered appropriately.

This amendment clarifies the order of authority of sources of established accounting principles that an auditor should follow in determining whether an accounting principle is generally accepted. Also, it adds to the sources of established accounting principles certain types of pronouncements that did not exist when SAS No. 5 was issued.

SAS No. 38, Paragraphs 47 and 51: Letters for Underwriters

This amendment would only remove the word *fairly* from several examples of letters expressing negative assurance. The language in those examples would now be consistent with SAS No. 36, *Review of Interim Financial Information*.

SAS No. 39, Paragraph 46: Audit Sampling

This amendment would delay, for one year, the date on which examination procedures applied to an entity's financial statements are required to be in conformance with the provisions of this statement. In response to comments from a number of CPA firms, the board believes that the additional time may be helpful to firms who are completing preparation of internal guidance that will be available for staff training during 1982. Earlier application is still encouraged by the board.

This exposure draft has been sent to

- *practice offices of CPA firms*
 - *members of AICPA Council and technical committee chairmen*
 - *state society and chapter presidents, directors, and committee chairmen*
 - *organizations concerned with regulatory, supervisory, or other public disclosure of financial activities*
 - *persons who have requested copies*
-

Proposed Statement on Auditing Standards

Omnibus Statement on Auditing Standards

Generally Accepted Auditing Standards

(Supersedes Statement on Auditing Standards No. 1, section 150.06.)

This amendment recognizes that certain generally accepted auditing standards (GAAS) apply to services covered by Statements on Auditing Standards, such as expressing an opinion on internal accounting control or reporting on the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement.

Services Other Than Examinations of Financial Statements

.06 In addition to examinations of financial statements, the ten generally accepted auditing standards, to the extent that they are relevant in the circumstances, apply to all other services governed by Statements on Auditing Standards unless the statement specifies otherwise.

The Auditor's Study and Evaluation of Internal Control

(Supersedes Statement on Auditing Standards No. 1, section 320.51 through .55.)

This amendment clarifies certain aspects of the review phase of the auditor's study and evaluation of internal accounting control, including (a) the minimum study and evaluation of internal accounting control that is required as a part of an examination of financial statements if the auditor does not plan to rely on the entity's internal accounting control procedures, (b) the requirement for an evaluation of the design of internal accounting control procedures on which the auditor plans to rely, and (c) the auditor's documentation of his review of the system of internal accounting control.

Review of System

.51 The purpose of the review of the system is to obtain sufficient knowledge and understanding about the accounting system and the internal accounting control system to make a determination of whether there are internal accounting control procedures that may provide a basis for reliance thereon in determining the nature, extent, and timing of substantive tests.¹

.52 The preliminary phase of such a review should be designed to provide the auditor with an understanding of the control environment and the flow of transactions through the accounting system. An understanding of the control environment should provide the auditor with a general knowledge of the methods used by the entity to communicate responsibility and authority; management's supervision of the system, including the existence of an internal audit function, if any; and the competence of personnel. An understanding of the flow of transactions should provide the auditor with a general knowledge of the various classes of transactions and the methods by which they are authorized, executed, initially recorded, and subsequently processed, including the methods of data processing. The auditor's understanding ordinarily is obtained by a combination of inquiry, observation, and reference to appropriate documentation.

.53 On completion of the preliminary phase of the review, an auditor may conclude that further study and evaluation are unlikely to justify any restriction of substantive tests. An auditor also may conclude that the audit effort required to study and evaluate the design of the system and to test compliance with the prescribed control procedures to justify reliance on them to restrict the extent of substantive tests exceeds the reduction in audit effort that could be achieved by such reliance. Such a conclusion may result from consideration of the nature or amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests. Either conclusion would cause an auditor to discontinue fur-

ther study and evaluation of the internal accounting control system and to design substantive tests that do not contemplate reliance on such internal accounting control procedures.²

.54 If, after the completion of the preliminary phase of the review, the auditor plans to rely on the system of internal accounting control, he should complete the review of the design of the system to determine whether the accounting control procedures are suitably designed to prevent or detect errors or irregularities. The auditor should consider the effectiveness of the specific control procedures, either individually or in combination, in terms of their significance to the prevention or detection of particular types of errors or irregularities concerning particular classes of transactions or balances. If one or more specific control procedures are adequate to prevent or detect a particular type of error or irregularity, the auditor need not consider other procedures. The absence or the inadequacy of one specific control procedure designed to prevent or detect a particular type of error or irregularity may not be a weakness if other, specific control procedures achieve the same purpose. The information required for the review of the design of the system ordinarily is obtained through one or more of the following procedures: inquiries of appropriate client personnel, inspection of written documentation, and observation of the processing of transactions and the handling of related assets.

.55 To clarify his understanding of information obtained from such sources, the auditor may trace one or a few of the different types of transactions involved through the related documents and records and observe the related internal accounting control procedures in operation. This practice may, if properly designed, be considered as a part of the tests of compliance, as discussed later in this section.

.56 On completion of the review of the design of the system, the auditor should make a preliminary evaluation of whether certain control procedures are suitably designed for him to rely on them for his purpose, assuming satisfactory compliance with those prescribed control procedures. Concepts to be considered in making either a preliminary or final evaluation are discussed in paragraphs [currently 320.64 through .68]. If control procedures are not suitably designed for the auditor to rely on them for his purpose, he would not test compliance with those controls, and, as a result, he would not restrict the extent of substantive tests based on reliance on those controls.

.57 The extent of the auditor's documentation of the review depends on the scope of the review, the nature of the entity's system of internal accounting control, and its documentation of that system. If the auditor decides not to extend the study and evaluation of internal accounting control beyond the preliminary phase of the review, he should indicate in his working papers the reasons for his decision and the effect on planned audit procedures. If the auditor decides to continue his study and evaluation, he should document his understanding of the system and the basis for his conclusion that the internal accounting control procedures on which he intends to rely are suitably designed to prevent or detect particular types of errors or irregularities concerning particular classes of transactions or balances. The auditor may document his understanding of the system and his conclusions about the design of that system in the form of answers to a questionnaire, narrative memoranda, flowcharts, decision tables, or any other form that the auditor considers appropriate in the circumstances.

Tests of Compliance

.58 The purpose of compliance tests is to provide reasonable assurance that the accounting control procedures are being applied as prescribed. Such tests are necessary if the prescribed procedures are to be relied on in determining the nature, timing, or extent of substantive tests of particular classes of transactions or balances, as discussed later in paragraphs [currently 320.57 through .63], but are not necessary if the procedures are not to be relied on for that purpose. The discussion of compliance tests in the remainder of this section applies only to those portions of the system of internal accounting control on which the auditor will rely in determining the nature, timing, and extent of substantive tests.

²The accounting system is distinguishable from the system of internal accounting control. An accounting system comprises the coordinate functions by which exchanges of assets or services with parties outside the business entity and transfers or use of assets or services within it are recognized, and data representing such exchanges, transfers, and uses are assembled, processed, analyzed, and reported. The objectives of internal accounting control are described in section 320.28.

³SAS No. 31, paragraph 11, provides guidance on the design of substantive tests.

Receivables and Inventories

(Amends Statement on Auditing Standards No. 1, section 331.14 and .15.)

This amendment modifies the procedures the auditor should apply if inventories are held in public warehouses.

Inventories Held in Public Warehouses¹

.14 If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets, to obtain reasonable assurance of their existence and valuation, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances. The auditor should —

- a. Review and test the owner's control procedures for investigating the warehouseman and evaluating the warehouseman's performance.
- b. Obtain an independent auditor's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.
- c. Observe physical counts of the goods, if practicable and reasonable.
- d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

¹See section 901 for the *Special Report of the Committee on Auditing Procedure*.

Consistency of Application of Generally Accepted Accounting Principles

(Supersedes Statement on Auditing Standards No. 1, section 420.15 and .16.)

This amendment removes the need for a qualification regarding consistency with respect to variations between periods in the terms used to express changes in financial position if adequate disclosure of the changes has been made in the financial statements.

Variations in Presentation of Statement of Changes in Financial Position

.15 In paragraph 8 of APB Opinion 19 (AC section 2021.08), the Accounting Principles Board concluded that "the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position." In paragraph 9 of that opinion, however, the board recognized "the need for flexibility in form, content, and terminology" in the statement of changes. Accordingly, variations between periods in the format of the statement of changes (such as changing to or from a balanced form) and in the terms used to express changes in financial position (such as changing from "working capital" to "cash" or "cash and cash equivalents") are reclassifications and do not involve the consistency standard. If such variations materially affect comparability, they should be disclosed in the financial statements, but ordinarily they will not be referred to in the independent auditor's report.

Public Warehouses — Controls and Auditing Procedures for Goods Held

(Supersedes Statement on Auditing Standards No. 1, section 901.01 through .05, .28, and .32.)

This amendment (a) deletes section 901.01 through .05, which contains historical material relating to the initial issuance of section 901 that is no longer considered relevant, (b) adds a new first paragraph that describes the applicability of section 901, (c) modifies the procedures described in section 901.32 that the auditor should apply if inventories are held in public warehouses to correspond with the proposed revision of SAS No. 1, section 331.14, and (d) makes various editorial changes.

.01 This section discusses internal controls of a public warehouse, the procedures of its independent auditor with respect to goods in the warehouse's custody, and auditing procedures performed by the independent auditor of the owner of goods in the warehouse.¹

Controls and Auditing Procedures for Owner's Goods Stored in Public Warehouses

.28 The following paragraphs provide guidance on the elements of internal control for the owner of the goods and on the auditing procedures to be employed by his independent auditor.

Procedures of the Independent Auditor

.32 SAS No. 1, section 331.14, describes the procedures that the auditor should apply if inventories are held in public warehouses.

¹This section reports the conclusions of a 1966 study of the committee on auditing procedure on the accountability of warehousemen for goods stored in public warehouses.

Reports on Audited Financial Statements

(Amends Statement on Auditing Standards No. 2, paragraph 39.)¹

This amendment clarifies the appropriate wording of an auditor's report that is qualified because of an uncertainty.

.39 An example of a report qualified because of an uncertainty affecting the financial statements follows:²

(Separate paragraph)

As discussed in Note X to the financial statements, the company is defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. Company officers and counsel believe the company has a good chance of prevailing, but the ultimate outcome of the lawsuits cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(Opinion paragraph)

In our opinion, subject to the effects of such adjustments, if any, that might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly. . . .

¹This statement also withdraws the auditing interpretation, *Reporting on an Uncertainty*, issued in October 1979 (AU section 9509.29-.32).

²The following example is appropriate in those rare instances when resolution of an uncertainty will be accounted for as a prior period adjustment:

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly. . . .

The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report

(Supersedes Statement on Auditing Standards No. 5, paragraphs 5 and 6.)¹

This amendment clarifies the hierarchy of accounting literature that an auditor should consider as sources of established accounting principles and adds new types of pronouncements to the examples of such sources.

.05 Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are experts in those accounting principles and determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The sources of established accounting principles are generally the following:

- a. Pronouncements of an authoritative body designated by the AICPA Council to establish accounting principles, pursuant to rule 203 of the AICPA Code of Professional Ethics
- b. Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing existing practices that are generally accepted
- c. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted
- d. Other accounting literature

.06 Category (a), officially established accounting principles, includes Financial Accounting Standards Board Statements of Financial Accounting Standards, FASB Interpretations, and, unless expressly superseded by FASB action, Accounting Principles Board Opinions and AICPA Accounting Research Bulletins. Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncement would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Interpretation 203-1 of the AICPA Code of Professional Ethics states, "There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading." Nevertheless, rule 203 provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. When the unusual circumstances contemplated by rule 203 exist and the statements depart from a pronouncement, the auditor's report should present, in a separate paragraph or paragraphs, the information required by rule 203, including a description of the departure, its approximate effects, if practicable, and the reasons why the departure is necessary to prevent the financial statements from being misleading. In those circumstances, however, unless there are reasons other than the departure to modify his opinion, the auditor should express an unqualified opinion on conformity with generally accepted accounting principles.

.07 If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. Categories (b) and (c) are both sources of established accounting principles. Category (b) includes AICPA Industry Audit Guides and Accounting Guides and AICPA Statements of Position; category (c) includes FASB Technical Bulletins and AICPA Accounting Interpretations, as well as industry practices that are widely recognized and prevalent in the industry. If an established accounting principle from one or more sources in category (b) or (c) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between sources within those categories, the auditor should consider which treatment better presents the substance of the transaction in the circumstances.

.08 In the absence of a pronouncement covered by rule 203 or another source of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.⁴ Other accounting literature includes, for example, APB Statements, AICPA Issues Papers, FASB Statements of Financial Accounting Concepts, pronouncements of other professional associations or regulatory agencies, and accounting textbooks and articles. The appropriateness of other accounting literature as a source of established accounting principles depends on its relevance to particular circumstances, the specificity of the

¹This statement also withdraws the auditing interpretation, *Accounting Principles Recommended by Trade Associations*, issued in November 1974 (AU section 9410.01-.03).

⁴The auditor should be aware that the accounting requirements adopted by regulatory agencies for reports filed with them may differ from generally accepted accounting principles in certain respects. SAS No. 1, section 544.04, and SAS No. 14, *Special Reports*, provide guidance if the auditor is reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

guidance, and the general recognition of the issuer or author as an authority. For example, FASB Statements of Financial Accounting Concepts or AICPA Issues Papers would normally be more influential than accounting textbooks or articles.

Letters for Underwriters

(Amends Statement on Auditing Standards No. 38, paragraphs 47 and 51.)

This amendment revises certain of the examples of letters for underwriters to make the expression of negative assurance contained in those examples consistent with SAS No. 36, *Review of Interim Financial Information*, by deleting the word *fairly*.

Example A: Typical Letter

- .47c ii. Are presented in conformity with generally accepted accounting principles on a basis substantially consistent with that of the audited financial statements and schedules included in the registration statement.

Text of Example Letter

- 4a ii. (2) whether those consolidated condensed financial statements are presented in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement.

- 5a. (ii) the unaudited consolidated condensed financial statements are not presented in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements; or

Example E: Alternate Wording When Recent Earnings Data Are Presented in Capsule Form

- .51.4c. (ii) whether those unaudited consolidated condensed financial statements are presented in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, and

Text of Example Letter

- 5a. (ii) those unaudited consolidated condensed financial statements are not presented in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements;

Audit Sampling

(Amends Statement on Auditing Standards No. 39, paragraph 46.)

This amendment changes the effective date of this statement from June 25, 1982, to June 25, 1983.

- .46 This statement is effective for examinations of financial statements for periods ended on or after June 25, 1983. Earlier application is encouraged.